Virginia Society of
Certified Public
Accountants

Virginia Tax Conformity

2018 and Beyond

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Executive Summary

The Virginia Society of Certified Public Accountants (VSCPA) is the professional association of the Commonwealth's CPAs, representing more than 13,500 members in public accounting, business and industry, government and education. The VSCPA has a longstanding position promoting early adoption of Virginia tax conformity to federal law, and with this in mind, the VSCPA has developed its position on the impact of the Tax Cuts and Jobs Act of 2017 (TCJA) on Virginia taxpayers and recommendations for the Governor and the General Assembly.

The VSCPA strongly recommends the following actions:

- Pass Virginia tax conformity for 2018 tax returns as early as possible and align Virginia tax law to federal law as closely as possible.
- Automatically apply abatement for any tax penalties incurred due to uncertainty regarding the adoption of federal changes by Virginia and require no action to be taken by taxpayers or their representatives.
- Sequester any new revenue gained for calendar year 2018 by conforming to federal law until a decision on policy is made, which is similar to the action Virginia took after sweeping new federal tax law in 1986.
- Delay the effective date to *no earlier than Jan. 1, 2019*, for any tax policy changes resulting from conformity to the TCJA, including adjustments to the individual and business provisions to provide relief for taxpayers adversely impacted by the federal changes.
- Delay the effective date to *no earlier than Jan. 1, 2019*, for comprehensive tax reform, in order to permit an accounting for additional revenues and to permit orderly and efficient implementation of the impact of the TCJA on Virginia and result in full conformity to federal tax law.

Complexity and Uncertainty of TCJA's True Impact

Signed into law on Dec. 22, 2017, the TCJA is the most significant change in federal tax law since 1986. Some provisions of the bill were retroactive to Jan. 1, 2017. Most portions of the bill that relate to individuals are temporary, with an expiration date of Dec. 31, 2025, while those associated with business taxpayers are mostly permanent. Due to its complexity, the TCJA introduces significant uncertainty, some of which will require Congressional action to correct. Historically, clearing up uncertain areas of tax reform is nothing new; it took five years after the Tax Reform Act of 1986 was enacted for Congress to pass comprehensive technical correction legislation. Given the political climate in Washington, passage of additional tax legislation is far from certain.

Lack of guidance from the U.S. Internal Revenue Service (IRS) has made assessing the impact of the TCJA difficult. It is expected that states will reap additional revenues beginning in calendar year 2018 as the result of the legislation, particularly those 38 states, including Virginia, that conform to federal law. Although several sources estimate the potential impact of the TCJA, these are estimates that cannot be confirmed until we complete the 2018 tax season.

To add additional complexity, the planned expiration of the TCJA's individual provisions require Virginia to adopt tax policies that incorporate the same expiration date into any Virginia tax law changes affecting individuals. The federal tax changes are projected to add to the federal deficit, which may result in reductions in other amounts received by Virginia from the federal government. Any changes to Virginia tax law should consider the possibility of those reductions, the size and scope of which, if any, are currently unknown. As Virginia is currently in the first year of its biennial budget, responsible planning also requires that any comprehensive tax reform in the Commonwealth be deferred until the next budget cycle, when the effects are better known and all stakeholders have the opportunity to participate in the discussion.

Background on Tax Conformity

When determining appropriate positions on Virginia tax matters, the VSCPA follows six guiding principles, which are outlined in Appendix A. For the 2018 tax year, we believe the focus should remain on the first principle, conformity. This approach will provide clarity early in the tax season for taxpayers, tax preparers, the business community, software developers and the Virginia Department of Taxation (TAX).

Principle of Conformity — Whenever possible, Virginia's tax laws should conform to federal tax laws. There should be as little delay as possible between the passage of federal tax law changes and adoption by the Commonwealth.

While 38 states conform to the U.S. Internal Revenue Code (IRC), Virginia, along with 17 other states, uses static conformity as the means to conform to federal law. Conformity is the adoption of federal **definitions** of income. Conformity DOES NOT include alignment to federal tax rates, tax brackets, exemption amounts, deduction amounts or credits. Virginia sets its own tax rates, tax brackets, exemption amounts, deduction amounts and credits.

Each year, the Virginia General Assembly passes retroactive emergency legislation to bring the Commonwealth into conformity with federal tax law as of a fixed date, albeit with certain exceptions. Conformity for individuals is the calculation of federal adjusted gross income; for businesses, it is federal taxable income. Any exceptions are treated as additions or subtractions when calculating Virginia taxable income. Current law conforms to the IRC as of Feb. 9, 2018, with exceptions for bonus depreciation, certain net operating loss carrybacks and the reduction in the medical expense deduction floor among them. However, the current statute does not encompass TCJA changes beyond those affecting 2017 returns, and the General Assembly did not address the issue in 2018 Special Session I on the current biennial budget adopted this past summer. As a result, Virginia taxpayers have been unable to plan for 2018.

Conformity Recommendations for 2019 General Assembly Session

Pass Conformity for 2018 Tax Year Early in the 2019 Session

The 2019 General Assembly session is a short session, and tax season begins in January. Therefore, tax conformity legislation for 2018 returns should be a priority, should be passed as early as possible and should adhere as closely to the federal law as possible. Early passage and full conformity would minimize complexity and streamline tax administration and compliance.

For example, failure to conform will require individuals to make up to 20 complex modifications to their returns, and businesses would be required to make up to 30 additional modifications. Additionally, failure to adopt conformity quickly will make it difficult and costly for taxpayers to timely file their returns because tax preparation software and filing systems, including those of the Virginia Department of Taxation, cannot be updated until this decision is made. We are also concerned Virginia taxpayers may incur penalties related to underpayment of their tax liabilities. Those penalties should be abated and such abatement should be automatic.

For business returns, the VSCPA recommends early and complete conformity. Existing provisions that do not conform to federal law should be eliminated, thereby reducing complexity in business return preparation. For individual returns, the VSCPA also recommends early and complete conformity. The TCJA included a temporary reduction in the medical expense deduction floor for individual returns for 2017 and 2018. The legislature chose not to conform to this provision for 2017, which added to the complexity in the preparation of 2017 returns. The reduced floor should be allowed for Virginia 2018 returns.

Sequester of Any Funds Generated by Conformity

The VSCPA understands the possibility of Virginia generating additional tax revenue from conforming, although it is uncertain what amount would be generated. We suggest the Commonwealth establish a separate fund to capture any Virginia revenues generated from conforming to the TCJA until the actual amount can be determined. This is a similar approach to the action taken in response to the Tax Reform Act of 1986, and would allow the flexibility and time for a thoughtful dialogue regarding tax policy changes.

Delay Effective Date of Tax Policy Changes to Jan. 1, 2019

We strongly believe comprehensive tax reform and new tax policy changes to individual and business provisions must have effective dates of no sooner than Jan. 1, 2019. We understand the urgent need to address tax policy, although we believe the debate and discussion may take longer than practicable for the 2018 tax year. The sequestration of any and all additional new revenue generated by conformity in 2018 will allow lawmakers the time to debate, discuss and decide the best route forward for Virginia. It will also provide taxpayers the certainty needed to file and fulfill their 2018 tax obligation.

Analysis of 6 Policy Options for 2019 Tax Year and Later

The VSCPA evaluated six policy options Virginia can take and outlined the impact of each option. This analysis does not promote any option over the others, and we acknowledge many other options are available. This analysis is offered as a tool in evaluating some of the more prominent options. **We strongly recommend these, or other options, only be considered for tax years 2019 and after.**

1. **Increase the standard deduction.** Increasing the standard deduction would maintain full conformity, which would affect all taxpayers but would be of greater benefit to those who previously itemized deductions. The financial impact of such a change varies depending on the amount of the increase. Doubling of the standard deduction is estimated to cost $400 million.
2. **Allow taxpayers to itemize on their Virginia returns even if they take the standard deduction on their federal returns.** Allowing itemization would permit all taxpayers to elect the filing method which best minimizes their tax liability. However, this would also make it difficult to make accurate revenue projections and create corresponding instability for the Commonwealth's budget. Taxpayers not utilizing the services of a tax practitioner or without access to tax preparation software may have difficulty understanding this option. Proportionally, this method provides greater relief to taxpayers in middle and higher income brackets. It is difficult to estimate the cost of this option since it is dependent on individual taxpayer decisions.
3. **Increase the personal exemption amount.** As a tradeoff for the increased standard deduction, the TCJA temporarily eliminates the ability of taxpayers to claim deductions for personal and dependency exemptions on their federal return, setting the value for each at zero dollars. This has no effect on the exemptions claimed on Virginia returns since the value of each exemption is determined by Virginia law, currently $930 for each personal exemption for the taxpayer(s) and dependents and an additional $800 for age and/or blindness of the taxpayer(s). An increase to the exemption amount would provide relief for all taxpayers, especially families with children and other dependents, as all Virginia taxpayers are able to claim the deduction. How this change would affect the general fund, however, varies depending on the amount of the increase. Doubling of the exemption is estimated to cost $334 million.
4. **Reduce tax bracket amounts.** Reducing tax brackets permits tax reform to be based upon the current system of taxation among various income levels of Virginia taxpayers. The cost of this option varies depending on the changes to each bracket.
5. **Increase filing thresholds.** Similar to reducing tax bracket amounts, increasing the filing thresholds permit tax reform to be based upon the current system of taxation among various income levels of Virginia taxpayers. The cost of this option varies depending the amount of the increase.
6. **Increase the benefits of the Earned Income Tax Credit (EITC).** Increasing the benefits of the EITC would have a significant effect on taxpayers with Virginia adjusted gross income of $54,000 or less. The cost of this option varies depending on how the benefit is modified.

Additional Items for Consideration

We recommend that Virginia make adjustments for individuals and businesses to address increased Virginia tax liabilities created by the TCJA. Additionally, we urge caution in the decision-making process given the uncertainty created by many of the TCJA's temporary individual provisions. Consider applying parallel expiration provisions to any adjustments.

The passage of TCJA and the recent U.S. Supreme Court decision in *South Dakota v. Wayfair, Inc.* provide Virginia a unique opportunity to review its entire tax structure, not just the income tax portion. A holistic approach will take into consideration not only the TCJA but also the effects on Virginia's revenues of the recent *Wayfair* case. The process Virginia undertook in the wake of the Tax Reform Act of 1986 (TRA '86) is instructive.

Should additional revenues permit, in addition to considering tax relief, other priorities that benefit Virginia taxpayers for which these funds could be evaluated. These priorities could be instituted either as a one-time expenditure or on a short-term basis for expenditures that are not a permanent part of Virginia's budget. Increasing the size of the state reserves, funding the unfunded liabilities noted in the Commonwealth's annual report by the Comptroller, and eliminating the accelerated sales tax are just a few examples of how the additional funds could be used to strengthen our Commonwealth's economy and fiscal future.

Undertaken as a part of the next budget cycle, the VSCPA recommends comprehensive tax reform be as transparent as possible, utilizing either an advisory group or a commission, and include representatives from all of the stakeholders, including tax practitioners. We would be happy to provide members of the VSCPA to serve.

In addition, we recommend the following while considering tax policy changes:

- **Full conformity with federal law.** Full conformity is the starting point for comprehensive tax reform. Any existing deconforming provisions should be fully conformed to the IRC. We are well aware that some provisions of full conformity, such as bonus depreciation and the §179 deduction, will result in lower revenue to the Commonwealth. Other provisions will result in increased revenues. The temptation to deconform for provisions like these may be great; nevertheless, we urge you to avoid the temptation, as deconformity adds to complexity. Simplicity is the goal. Note also that full conformity includes the sunset dates and phase-outs, thereby ensuring that the revenue to the Commonwealth is more predictable, which will be useful in planning.
- **Inflation indexing.** Many of the federal provisions include increases indexed to inflation, using the chained consumer price index. Virginia should use the same mechanism to index its individual personal and additional exemption amounts.
- **Individual tax relief.** The impact of the TCJA places the highest financial burden on individual taxpayers in Virginia and any relief should be

Additional Items for Consideration

similarly targeted to individual taxpayers providing equity and recognizing an opportunity for meaningful tax reform among taxpayers.
- **Penalty relief.** Given the complexity of the TCJA and the lack of guidance on many provisions from the IRS, mistakes are bound to happen in tax preparation. The Virginia Department of Taxation must be authorized to waive penalties due to the uncertainties of the law.

In conclusion, the VSCPA respectfully recommends that the General Assembly act as quickly as possible to conform to the IRC in all material respects, and that comprehensive state and local tax reform discussions be delayed until the next budget biennium. Please direct questions to VSCPA Vice President, Advocacy Emily Walker, CAE, at ewalker@vscpa.com or (804) 612-9428.

Appendix A: VSCPA Guiding Principles of Virginia Tax Policy

The VSCPA has developed guiding principles in tax policy to use as a framework when developing positions on tax-related legislative and regulatory matters. These guidelines recommend that Virginia tax laws and regulations meet the following guiding principles:

1. **Conformity:** Whenever possible, Virginia's tax laws should conform to federal tax laws. There should be as little delay as possible between the passage of federal tax law changes and adoption by the Commonwealth.
2. **Simplicity:** Earliest possible conformity helps to minimize complexity in Virginia return preparation, allowing taxpayers to accurately comply with the rules in a cost-efficient manner.
3. **Transparency:** Changes to Virginia's tax laws should be undertaken in an inclusive and transparent manner, allowing ample time for all stakeholders to become familiar with proposed changes and provide feedback to policymakers.
4. **Equity:** Any changes to the law should be equitable — based on the taxpayer's ability to pay, with consideration of both horizontal and vertical equity. Horizontal equity is achieved when two similarly situated taxpayers pay the same amount. Vertical equity is achieved when taxpayers with greater ability to pay taxes pay more than taxpayers with less ability to pay.
5. **Certainty:** Tax rules should clearly specify when and how a tax must be paid, and how the amount due is determined, which aids in tax planning and estimated tax payments.
6. **Competitiveness:** Virginia's economy cannot be viewed in a vacuum. Our tax structure should be designed to enhance the Commonwealth's competitive position in the region, the country and the world. Maintaining Virginia's AAA bond rating and rank among the best states to do business and raise children is critical to our attractiveness for businesses, individuals and investors.